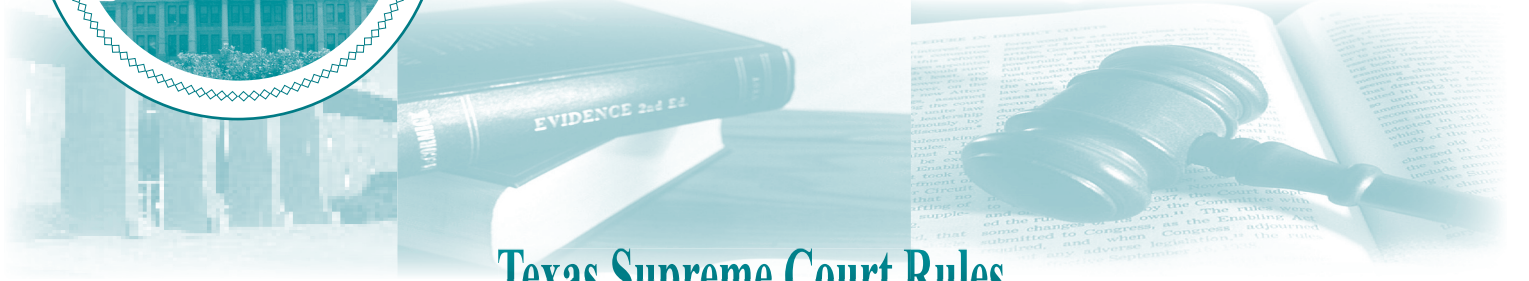




Research SPOTLIGHT

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Texas Supreme Court Rules School Finance System Does Not Make the Grade

There is substantial evidence...that the public education system has reached the point where continued improvement will not be possible absent significant change, whether that change take the form of increased funding, improved efficiencies, or better methods of education. ...But an impending constitutional violation is not an existing one, and it remains to be seen whether the system's predicted drift toward constitutional inadequacy will be avoided by legislative reaction to widespread calls for changes.

—Justice Nathan Hecht
*Neeley, et al. v. West Orange-Cove
Consolidated Independent
School District, et al.*

On November 22, 2005, in *Neeley, et al. v. West Orange-Cove Consolidated Independent School District, et al.*, the Texas Supreme Court, with one justice dissenting and another not participating, ruled that the maximum tax rates set under the Texas public school finance system for local property taxes had in effect become an unconstitutional state-mandated ad valorem tax in violation of Article VIII, Section 1-e, of the Texas Constitution, which bars the imposition of a state ad valorem tax. The majority found that some school districts were being forced to tax at the maximum tax allowed under the system to meet minimum state accreditation standards and therefore no longer had any meaningful discretion to choose the local tax rate. Although the majority did conclude that current deficiencies and disparities in the generation and distribution of revenue in the public school finance system did not amount to violations of Article VII, Section 1, of the Texas Constitution, which requires the legislature to establish and make suitable provision for the support and maintenance of an efficient system of free public schools for the general diffusion of knowledge, the opinion warned that defects in the structure of the system expose it to constitutional challenges. Pouring more money into the system may forestall such challenges, the majority declared, but only for a time, unless the current public school system is overhauled. The majority declared that structural changes, and not merely increased funding, are needed in the public education system to meet the constitutional challenges that have been raised. The decision gives the Texas Legislature a deadline of June 1, 2006, to address the tax issue.

This brief looks at the background of this case and summarizes the decision in detail.



BACKGROUND

Article VII, Section 1, of the Texas Constitution provides that:

A general diffusion of knowledge being essential to the preservation of the liberties and rights of the people, it shall be the duty of the legislature of the State to establish and make suitable provision for the support and maintenance of an efficient system of free public schools.

The Texas Supreme Court has interpreted this provision as setting up three standards a public school system must meet to pass constitutional muster:

- the public school system must be efficient, meaning that children living in property-poor and property-rich districts must be afforded a substantially equal opportunity to have access to educational funds (the terms “property-poor” and “property-rich” refer to the taxable property wealth in a district);
- public schools must be adequate, meaning that the schools must accomplish a general diffusion of knowledge essential to the preservation of the liberties and rights of the people; and
- public education must be suitable in that the public school system must be structured, operated, and funded so that it can accomplish its purpose for all Texas children.

Article VIII, Section 1-e, of the constitution bars the levying of state ad valorem taxes upon any property in Texas.

In 1989, in *Edgewood Independent School District v. Kirby*, 777 S.W.2d 391 (Tex. 1989), the Texas Supreme Court ruled that the state’s public school finance system, with its heavy dependence on local property taxes, violated Article VII, Section 1. The system, declared the court, resulted in wide disparities in the quality of public education between poorer and wealthier school districts and therefore was efficient neither financially nor in the general diffusion of knowledge. The disparities resulted from the amount of taxable property wealth in each district, with property-poor districts having to impose higher taxes to obtain relatively little revenue, while property-rich districts in wealthier areas of the state could impose lower taxes yet still achieve substantially higher revenues. The Texas Legislature responded with legislation that was subsequently challenged, resulting in a series of cases known as the *Edgewood* cases.

In 1995, in *Edgewood Independent School District v. Meno* (often referred to as *Edgewood IV*), 893 S.W.2d 450 (Tex. 1995), the court, in a five-to-four decision, ruled that the revised system implemented under S.B. 7 enacted by the 73rd Texas Legislature met constitutional muster. However, the majority opinion warned that the new system, because of remaining funding disparities, could again become unconstitutional.

The warning in *Edgewood IV* concerned Article VIII, Section 1-e. The funding system challenged in *Edgewood IV* created a two-tiered system:

- Tier one guarantees sufficient financing for all school districts to provide a basic program of education that meets accreditation and other legal standards. Under this tier, a school district that cannot generate revenue equal to a “basic allotment” through the minimum tax rate receives state funds to make up the difference.
- Tier two provides for partially state-supported local supplementation. Under this tier, for each penny a district raises the tax rate above the minimum, the state guarantees a certain yield per weighted student. The tax rate for maintenance and operations (M&O) is capped at \$1.50, subject to various adjustments and exceptions. There is also some state funding for facilities, sometimes referred to as tier three, in the system.

S.B. 7 addressed disparities in M&O revenues among districts two ways:

- supplementation of property-poor district tax revenues with state funds through the Foundation School Program (FSP); and
- a recapture program, popularly referred to as “Robin Hood,” under which property tax revenue is transferred from property-rich districts to property-poor districts. However, there was an exception for districts taxing at the maximum \$1.50 tax rate, allowing these “hold harmless” districts to retain more of their revenue. This provision, intended to mitigate the impact of S.B. 7, was initially intended to be phased out. However, it was not, and there are currently 34 hold-harmless districts, educating less than one percent of Texas students.

The bill also imposed a cap on a district’s taxable property at a level of \$280,000 per student, which was to be phased in over three years. Any district exceeding this \$280,000 cap could elect one of five options to bring its

taxable property within this cap. If a district failed to successfully exercise one of these options, district property could be annexed to another district, and if this failed to reduce the district's taxable property, the district could be consolidated with another district or districts.

The majority in *Edgewood IV* ruled that this system did not impose an unconstitutional state ad valorem tax because, while it did set minimum and maximum tax rates, districts and their voters still had the discretion within these parameters to choose the tax rate and control the distribution of the proceeds. However, the court warned that if the cost of education rose to the point that a district was forced to tax at the maximum tax allowed under the bill just to meet minimum accreditation standards, the tax would in effect become an unconstitutional state-mandated ad valorem tax.

The majority also warned that:

- while districts might be able to generate revenues to supplement an efficient system, supplementation cannot become so great that it destroys the efficiency of the system; and
- because the bill lacked a separate component for funding school facilities, if educational costs rose to the point that a school district was unable to meet its operations and facilities needs within the funding program established by the legislature, the state will once again have failed to fulfill its constitutional obligation to provide an efficient education system.

In April of 2001, a number of public school districts led by West Orange-Cove Consolidated Independent School District filed suit, asserting that under the school finance system, local property taxes have effectively become an unconstitutional state-mandated ad valorem state tax. Two other groups, comprising additional districts led by Edgewood Independent School District and Alvarado Independent School District, intervened, contending that the school finance system violated the state constitution because children in property-poor districts do not have substantially equal access to educational revenue. All these groups asserted that the Texas public school system fails to achieve a general diffusion of knowledge as required under the Texas Constitution because the system is underfunded. The claims were consolidated into one case. The district court dismissed the action on the ground that the plaintiffs had failed to state a claim, and the appellate court affirmed the decision.

On May 29, 2003, in *West Orange-Cove Consolidated*



I.S.D. v. Alanis, 107 S.W.3d 558 (Tex. 2003), a majority of the Texas Supreme Court (seven justices, with another concurring in the judgment) reversed the lower court decisions dismissing this action and remanded the case to the trial court for further proceedings. The majority ruled only that the allegations in the plaintiffs' petition were sufficient to state a claim that the state's system of funding public education in effect forced the districts to impose a state ad valorem tax, which is barred by the Texas Constitution. The decision did not discuss the constitutionality of the state's current system of public schools, instead remanding this issue for consideration in the trial court. The state had argued in part that the plaintiffs' suit was not ripe because the system did not require all districts throughout the state to tax at the rate of \$1.50 and therefore did not result in a statewide ad valorem tax. The majority rejected this argument, stating that the constitution prohibits state ad valorem taxes upon any property within this state. The issue, the majority said, is not the pervasiveness of the tax, but the state's control over it. An illegal state ad valorem tax is a tax imposed by the state, either directly or indirectly. Therefore, the majority asserted, a single district could make a claim that it is unconstitutionally constrained by the state to tax at a particular rate. The state made four other arguments that the plaintiffs could not allege that they are forced to tax at maximum rates, all of which were rejected by the majority.

Upon remand, more districts joined the action. On November 30, 2004, the district court ruled in favor of the school districts, finding that the Texas school finance system:

- violates Article VIII, Section 1-e, of the Texas Constitution because the \$1.50 cap on M&O tax rates has become both a floor and a ceiling, denying school districts meaningful discretion in setting their tax rates;
- is financially inefficient, inadequate, and unsuitable because the school finance system fails to recognize or cover the costs of meeting the constitutional mandate of adequacy or the statutory definition of a comprehensive adequate program;
- deprives property-poor districts of substantially equal access to facilities funding in violation of the efficiency and suitability provisions of the Texas Constitution; and
- fails to provide sufficient access to revenue to provide for a general diffusion of knowledge in violation of the efficiency, suitability, and adequacy standards.

However, the district court rejected the claim that the funding of school maintenance and operations is also inefficient.

The district court enjoined the state from financing and funding public school education until the constitutional violations are remedied, but it stayed the injunction until October 1, 2005, in order to give the legislature a reasonable opportunity to cure the constitutional deficiencies in the finance system. However, the legislature was unable to enact a school finance plan either during its regular 2005 session or in subsequent special sessions. In the meantime, the state appealed the district court's ruling and the injunction was stayed.

Even if each category of evidence would not, by itself, prove a constitutional violation, all of this evidence taken together, along with the extensive record before us, clearly shows that school districts have lost meaningful discretion to tax below maximum rates and still provide an accredited education. . . . The question. . . is whether school districts have meaningful discretion to tax below maximum rates, and the answer is that they do not.

—Justice Nathan Hecht
*Neeley, et al. v. West Orange-Cove
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Opinion

The majority summarized the structure of the current school financing system, noting that the state funds only about 38 percent of the cost, down from about 43 percent in *Edgewood IV*, and representing the lowest level in more than 50 years. There are 1,031 independent school districts ranging in size from 211,499 students to as few as 10 students. The proliferation of local districts differing so enormously in size and wealth makes it difficult to create and maintain an effective school finance system. A system that operates with an excess of resources in some locales and a dearth in others is inefficient, so the system must compensate for disparities in the amount of property value per student so that property owners in property-poor districts are not burdened with much heavier tax rates than property owners in property-rich districts to generate substantially the same revenue per student for public education. The purpose of S.B. 7 was to make funding public education with local property taxes efficient by reducing the effects of the vast disparities among school districts.

The majority rejected the state's arguments that the school districts lacked standing to assert any constitutional claims and that the court lacked jurisdiction to decide the issues before it. Under the constitution, the majority explained, it is the duty of the legislature to provide for public education, but it is the judiciary's role to ensure that the constitutional standards are met, although it may not prescribe how these standards should be met.

Adequacy

Another issue was the test to be used in determining whether the public school finance system is adequate, efficient, and suitable. The majority declared that the test is whether the legislature acted arbitrarily in enacting the challenged aspect of the system. Article VII, Section 1, requires the legislature to structure a public school system that is adequate, efficient, and suitable, but, the majority stated, this provision grants the legislature much latitude in choosing among any number of alternatives that can reasonably be considered to meet those standards. Perfection is not required, but the standards must be satisfied and the legislature's discretion is not unbounded. For example, the majority explained, it would be arbitrary for the legislature to define the goals for accomplishing the constitutionally required general diffusion of knowledge and then provide insufficient means for achieving this goal. If the legislature's choices are informed by guiding rules and principles properly

related to public education, the majority declared, the legislature's choices are not arbitrary and the system does not violate the constitution. When assessing challenges to the public education system under Article VII, Section 1, the courts must not substitute their policy choices for the legislature's, but must instead examine the legislature's choices carefully to determine whether those choices meet the requirements of the constitution.

The majority agreed with the lower court's conclusion that, to fulfill the constitutional obligation to provide a general diffusion of knowledge, districts must provide their students with a meaningful opportunity to acquire the essential knowledge and skills reflected in curriculum requirements so that, upon graduation, students are prepared to continue to learn in post-secondary educational, training, or employment settings. However, the majority added the caveat that the public education system need not operate perfectly; it is adequate if districts are reasonably able to provide their students this access and opportunity.

The majority stated that the district court did not find that the public school system is so designed that it cannot accomplish a general diffusion of knowledge, but rather that the system is not producing a general diffusion of knowledge because the state has not provided sufficient funding. The majority noted that in the extensive case record there is much evidence that many schools and districts are struggling to teach an increasingly demanding curriculum to a population with a growing number of disadvantaged students, yet without additional funding needed to meet these challenges. There are wide gaps in performance among student groups differentiated by race, proficiency in English, and economic advantage. Non-completion and dropout rates are high, and the loss of students who are struggling may make performance measures applied to those who continue appear better than they should. The rate of students meeting college preparedness standards is very low. There is also evidence of high attrition and turnover among teachers statewide due to increasing demands and stagnant compensation. However, the majority noted that there is undisputed evidence that standardized test scores have steadily improved over time, even while tests and curriculum have been made more difficult. After reviewing

this evidence and the lower court's findings, the majority declared that it cannot conclude that the legislature has acted arbitrarily in structuring and funding the public education system so that school districts are not reasonably able to afford all students with access to education and the educational opportunity to accomplish a general diffusion of knowledge.

However, the majority warned that there is substantial evidence that the public education system has reached the point where continued improvement will not be possible absent significant change, whether that change take the form of increased funding, improved efficiencies, or better methods of education. "But," the majority continued, "an impending constitutional violation is not an existing one, and it remains to be seen whether the system's predicted drift toward constitutional inadequacy will be avoided by legislative reaction to widespread calls for changes."

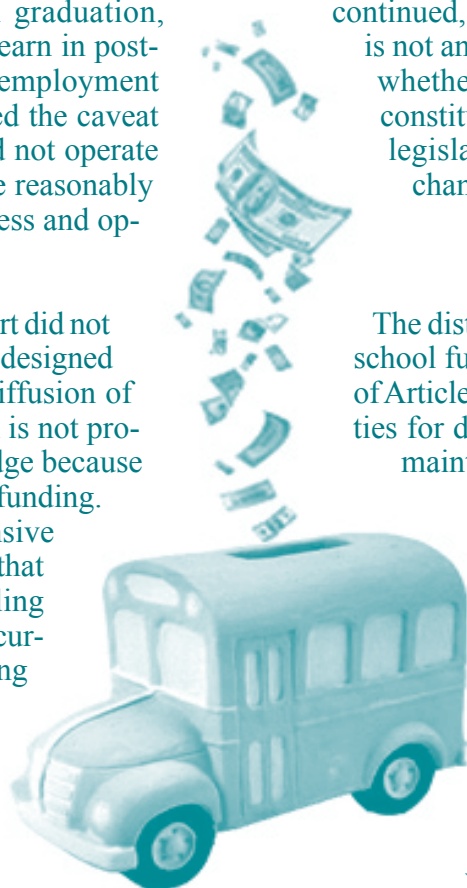
Efficiency

The district court had concluded that the public school funding system is inefficient in violation of Article VII, Section 1, in its provision of facilities for districts, but not in its provision for the maintenance and operation of the schools.

The majority stated that an efficient system of public education requires not only classroom instruction, but also the classrooms where that instruction is to take place. These components of an efficient system, instruction and facilities, are inseparable. Article VII, Section 1, requires an efficient system of free public schools considering the system as a whole, not a system with efficient components. Therefore,

the majority considered whether the inefficient provision of facilities found by the district court makes the entire system inefficient, or whether the system is inefficient for reasons apart from its provision of facilities.

For the system to be efficient, the majority explained, districts must have substantially equal access to similar revenues per pupil at similar levels of tax effort. Constitutional efficiency does not require absolute equality of spending and local communities are not precluded from supplementing an efficient system established by the legislature. The constitutional standard of efficiency



requires substantially equivalent access to revenue only up to a point, after which a local community can elect higher taxes to supplement and enrich its own schools. Once the legislature has discharged its duty to provide an adequate school system for the state, a local district is free to provide enhanced public education opportunities if its residents vote to tax themselves at higher levels.

The state argued that a system which provides a general diffusion of knowledge is also presumptively efficient as a matter of law and that the funding gaps cited by the intervenors are no worse than they were in *Edgewood IV*. The intervenors asserted that significant funding disparities do exist and have worsened in the decade since *Edgewood IV*.

The majority dismissed the issue of the hold harmless districts in considering whether the system is efficient, noting that it appears that the provisions favoring those districts reduce recaptured funds only about four percent. Although no party has made any effort to justify continuation of these districts, the majority held that it cannot say that such districts render the entire system inefficient.

The majority found that there is much evidence that many districts' facilities are inadequate. The state argued that disparities in available facilities among districts are not proof of inefficiency absent evidence that the districts' needs are similar. The state contended that facilities needs vary widely depending on the size and location of schools, construction expenses, and other variables. The majority agreed that such evidence is necessary, but is lacking. The state also asserted that to prove constitutional inefficiency the intervenors must offer evidence of an inability to provide for a general diffusion of knowledge without additional facilities, and that they have failed to do so. Again, the majority agreed, declaring that efficiency requires only substantially equal access to revenue for facilities necessary for an adequate system, rejecting the intervenors' claim that constitutional efficiency does not permit substantially unequal access to funds to supplement an adequate education. As long as efficiency is maintained, it is not unconstitutional for districts to supplement their programs with local funds, even if such funds are unmatched by state dollars and such funds are not subject to statewide recapture. Supplementation is simply additional revenue not required for an education that is constitutionally adequate; for such supplementation, districts need not have substantially equal access to funds. Accordingly, the majority concluded that the public school finance system is not

inefficient. However, the majority cautioned that the amount of supplementation in the system cannot become so great that it, in effect, destroys the efficiency of the entire system. The danger is that what the legislature today considers to be supplementation may tomorrow become necessary to satisfy the constitutional mandate for a general diffusion of knowledge.

Suitability

The district court concluded that the public education system is not suitable for the same reason it concluded that the system is inadequate and inefficient, namely because the funding is insufficient. The majority explained that suitability differs from the constitutional standards of adequacy and efficiency, referring specifically to the means chosen to achieve an adequate education through an efficient system. For example, if the funding system were efficient so that districts had substantially equal access to it and the education system was adequate to provide for a general diffusion of knowledge but districts were not actually required to provide an adequate education, the legislature's use of districts to discharge its constitutional duty would not be suitable, because the legislature would have employed a means that need not achieve its end.

The majority declared that neither the structure nor the operation of the funding system prevents it from efficiently accomplishing a general diffusion of knowledge. The state may discharge its duty to make suitable provision for free public schools through school districts by relying on local tax revenues, even as heavily as it now does. Such reliance, especially given the multitude and diversity of school districts, inevitably makes it difficult to achieve efficiency because of the vast disparities in local property wealth, but efficiency is not impossible. The majority noted that while the court has in the past suggested that these difficulties might be avoided by fundamental changes in the structure of the system, the possibility of improvement does not render the present system unsuitable for adequately and efficiently providing a public education. Accordingly, the majority concluded that the system does not violate the constitutional requirement of suitability.

Ad Valorem Tax

The majority agreed with the lower court that the state's control of local taxation for education amounts to a state property tax in violation of Article VIII, Section 1-e. Local tax rates have increased markedly since 1993-1994,

when only two percent of the districts, with one percent of the students, were taxing at the \$1.50 maximum M&O rate. Currently, 48 percent of the districts, with 59 percent of the students, are taxing at the cap, and 67 percent of the districts, with 81 percent of the students, are taxing at or above \$1.45. In 1993-1994, 90 percent of the districts, with 85 percent of the students, had tax rates below \$1.40; that group has now shrunk to 20 percent of the districts, with 10 percent of the students.

The majority noted that the court has previously held that an ad valorem tax is a state tax when the state so completely controls the levy, assessment and disbursement of revenue, either directly or indirectly, that the local taxing authority is without meaningful discretion. The system adopted by S.B. 7 sets maximum tax rates. Citing *Edgewood IV*, the majority stated that as the cost of providing for a general diffusion of knowledge continues to rise, the minimum rate at which a district must tax will also rise. Eventually, some districts are forced to tax at the maximum allowable rate just to provide a general diffusion of knowledge. When this cap on tax rates becomes in effect a floor as well as a ceiling, the legislature has in effect set a state ad valorem tax because the districts have lost all meaningful discretion in setting the tax rate. The majority also noted that it has previously rejected the state's argument that there is no constitutional violation unless all school districts, or at least most of them, are required to tax at the absolute maximum rate for no other reason than to provide an

accredited education. The issue, the court said, is not the pervasiveness of the tax, but the state's control of it and the lack of meaningful discretion.

The district court found that the plaintiffs' districts for which evidence was offered lacked meaningful discretion in setting their local property tax rates. There was detailed evidence showing how the districts are struggling to maintain accreditation with increasing standards, a demographically diverse and changing student population, and fewer qualified teachers, while cutting budgets even further. The state asserted that though facing increased challenges, the focus districts have met or exceeded all accreditation requirements, but the majority stated that it cannot be inferred from that fact that the districts could lower taxes and still meet those requirements. The district court credited evidence that districts statewide are spending over 97 percent of the revenue that would be available if every district taxed at maximum rates, up from 83 percent in 1993-1994. Only about a third of the districts with about a fifth of the student population exceed minimum accreditation standards. This, the majority stated, is a marked decline from 2001, when over 60 percent of the districts with well over half of the student population exceeded minimum accreditation standards. The current situation has become virtually indistinguishable from one in which the state simply set an ad valorem tax rate of \$1.50 and redistributed the revenue to the districts. The state also controls the expenditure of more than \$1 billion in local tax revenues recaptured from 134 districts; the number of districts and amount of revenue subject to recapture have almost tripled since 1994. The majority found that the state's control of this local revenue is a significant factor in considering whether local taxes have become a state property tax. All of this evidence taken together, the majority concluded, clearly shows that school districts have lost meaningful discretion to tax below maximum rates and still provide an accredited education.

Supplementation

The lower court also determined that the maximum tax rate should be \$1.35 rather than \$1.50 because school districts must have \$0.15 of tax rate, 10 percent of the maximum, available for local supplementation. Therefore, in the lower court's view, almost all school districts are taxing at maximum rates. The state argued that districts have no constitutional right to local supplementation, and therefore such expenditures should not be considered in determining whether school districts have meaningful discretion to tax below maximum rates.



The majority agreed that local supplementation is not a constitutional right, but it is part of the purpose of FSP funding. Section 42.301 of the Education Code states in part that the purpose of the guaranteed yield component (tier two) of the FSP is to provide each school district with the opportunity to provide the basic program and to supplement that program at a level of its own choice. Although the statute does not promise any particular level of supplemental funding, local supplementation is made a core component of the system structure, necessitated by the basic philosophy of the virtue of local control. The state, declared the majority, cannot provide for local supplementation, pressure most of the districts by increasing accreditation standards in an environment of increasing costs to tax at maximum rates in order to afford any supplementation at all, and then argue that it is not controlling local tax rates.

Tax Rate Cap

The majority noted that various legislative proposals during the past year to remedy perceived problems with the public education system and its funding would reduce the maximum ad valorem tax rate and allow it to be exceeded for certain purposes. While the majority said it would not express any view on the appropriateness of any of these proposals, it cautioned that a cap to which districts are inexorably forced by educational requirements and economic necessities will in short order violate the prohibition of a state property tax.

The majority also warned that simply removing the tax rate cap would destroy the equalization necessary for efficiency. The cap that makes the public education funding system a state property tax is also intended to keep the system efficient. Removing the cap so as to allow districts meaningful discretion in setting tax rates at higher levels would also increase the revenue disparity among the property-rich and the property-poor districts, creating the financial inefficiency that the cap is intended to prevent. Local ad valorem taxes provide more than half the revenue for the public school system. The constitutional violation cannot be corrected without raising the cap on local tax rates or changing the system.

Order

The majority agreed with the district court that the use of the current system must be enjoined. However, to allow the state time to fully consider structural changes in the public education system and to allow the system time to adjust to those changes, the majority postponed the effective date of the district court's injunction to June 1, 2006. The majority reversed and remanded the issue of attorney fees and costs and remanded the case to the district court to reconsider.

—by Sharon Weintraub, SRC



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